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The Oil Market Outlook Through 1985

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An Intelligence Assessment

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*GI 84-10039
February 1984*

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The Oil Market Outlook Through 1985

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An Intelligence Assessment

This paper was prepared by [redacted]
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**The Oil Market Outlook
Through 1985**

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Key Judgments

*Information available
as of 16 February 1984
was used in this report.*

Barring an oil supply disruption, the oil market should remain soft this year, according to our analysis and a review of recent industry forecasts. We expect non-Communist oil consumption to rise by only about 2 percent in 1984 to about 45 million barrels per day (b/d) in response to the economic recovery and continued erosion in real oil prices. Demand for Organization of Petroleum Exporting Countries (OPEC) oil is expected to approximate 19.5 million b/d—1 million b/d above 1983 levels.

The likelihood of a seasonal decline in demand this spring, however, will again test the cartel's resolve to maintain oil prices. At this point, we believe that Saudi Arabia will defend the current benchmark price—as long as other producers generally adhere to their production guidelines. If several OPEC countries facing financial problems opt to try to increase their market share or if oil consumption is lower than now anticipated, however, a downward oil price spiral could occur.

Even if OPEC holds the line on prices in 1984, as we expect, oil market conditions will remain soft in 1985. Given prospects for only a modest increase in consumption and the possibility of increased output from Iraq, other OPEC countries will be forced to maintain or even reduce production to prevent a price decline. In addition, OPEC will face new challenges to crude oil price stability, including increasing spot transactions, growing trade in futures contracts, and higher oil product exports whose prices are not fixed by the cartel.

Although we expect the market to remain weak over the coming months, the volatile situation in the Middle East could cause a rapid turnabout in the market. Specifically, as long as the Iran-Iraq war continues there is a risk that it could lead to an interruption in Persian Gulf oil supplies. Recent Iraqi attacks on Iranian cities and a petrochemical facility highlight this risk. Damage to almost any major oil facility could lead to a sizable runup in spot oil prices if the market believes there is a risk of further damage to other oil facilities. The resulting oil price increase could slow the economic recovery, add to inflationary pressures, and threaten to add to the debt problems of oil-importing less developed countries.

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February 1984

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Contents

	<i>Page</i>
Key Judgments	iii
Introduction	1
Recent Developments	1
The Outlook for 1984	3
Consumption Forecast	3
Inventory Patterns	3
Non-OPEC Oil Supply	3
Demand for OPEC Oil	5
The Price Stability Issue in 1984	5
Factors Supporting Market Stability	6
The Price Decline Scenario	7
Prospects for 1985	8
The Market Outlook	8
Iraq and Iran—Increased Production Possible	10
Other Market Pressures	11
Market Vulnerability—The Iran-Iraq Risk	14

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Table 1
Retail Petroleum Product Prices
in Selected Countries, 1982-83 ^a

US cents per US gallon

	Gasoline		Light Fuel Oil		Heavy Fuel Oil	
	1982	1983	1982	1983	1982	1983
	Price					
France	229	245	132	142	53	67
West Germany	211	204	124	111	60	60
Italy	264	302	121	164	53	63
United Kingdom	205	216	99	137	76	101
Japan	272	253	157	154	102	102
United States	122	116	117	107	69	68
	Tax					
France	121	132	28	32	8	10
West Germany	103	100	16	16	9	9
Italy	164	202	22	46	7	10
United Kingdom	100	120	4	4	4	4
Japan	85	85	0	0	0	0
United States	15	18	0	0	0	0

^a All data converted at February 1983 exchange rates.

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The Oil Market Outlook Through 1985

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Introduction

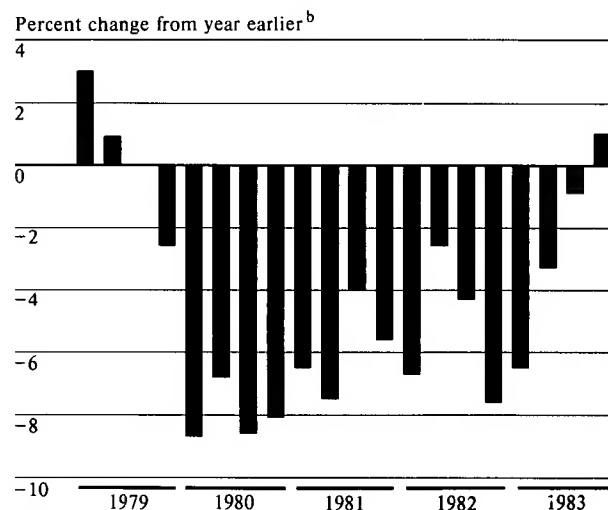
Despite a cold snap that increased consumption and tightened inventories early this year, weak oil demand and surplus supplies have kept downward pressure on oil prices. Whether oil prices remain weak will depend on a number of uncertainties that cloud prospects for the oil market in the coming year or two. In particular, the behavior of Organization of Petroleum Exporting Countries (OPEC), political turmoil in the Middle East, the ongoing impact of oil price increases of the 1970s, and the changing market structure will strongly influence market trends. Any one of these factors could alter the market and price outlook and have a measured impact on economic growth, debt problems, and political stability.

Recent Developments

Non-Communist oil consumption fell by 1 million b/d last year to approximately 44 million barrels per day—8 million b/d below peak 1979 levels. Industrialized countries accounted for most of the decline in oil use. Oil consumption in the United States and Japan fell 1 percent in 1983 while Western Europe registered a 5-percent decline. Depressed demand in Western Europe in part reflects the strength of the US dollar, which has increased fuel prices in local currencies (table 1). While complete data on recent oil consumption by less developed countries (LDCs) are unavailable, fragmentary information and industry data suggest that LDC oil use fell slightly last year.

Despite the year-over-year decline, preliminary data indicate non-Communist oil consumption in fourth-quarter 1983 rose by about 1 percent from year-earlier levels, the first such increase since 1979 (figure 1). Cold weather plus the US economic recovery were largely responsible for the modest rebound. Oil consumption in the fourth quarter in the United States and Japan rose by 3 percent and 2 percent, respectively. In contrast, sales in Western Europe declined by 2

Figure 1
OECD Oil Consumption Trends, 1979-83^a



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percent. Because of the continued decline in West European usage and a probable decline in LDC consumption, the fourth-quarter recovery in non-Communist demand for oil was less than most industry forecasters had anticipated.

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Industry efforts to eliminate excess inventories continued during 1983. We estimate non-Communist oil stocks, including floating storage, fell by about 1 million b/d last year. High production and lower-than-expected consumption levels during the fourth quarter, however, caused oil inventories to decline by only 500,000 b/d compared with a normal seasonal

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Table 2
Non-Communist Primary Oil Stocks on Land,
End of Period

	Billion Barrels				Days of Forward Consumption ^a			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
1978	3.6	3.7	3.9	3.9	74	76	74	70
1979	3.5	3.8	4.2	4.3	72	78	81	82
1980	4.3	4.6	4.8	4.6	91	99	97	93
1981	4.5	4.6	4.7	4.6	102	105	100	96
1982	4.3	4.2	4.3	4.3	97	98	97	95
1983	4.0	4.0	4.1	4.1	94	94	93	90 ^b

^a Estimates include government-owned stocks in Japan, West Germany, and the United States that have increased from 62 million barrels in first-quarter 1978 to about 520 million barrels at

the end of fourth-quarter 1983. The increase amounts to about 10 days of forward consumption.

^b Estimated.

decline of about 1 million b/d. We estimate oil stocks on land at yearend stood at about 4.1 billion barrels or about 90 days of forward consumption (table 2). Nearly 520 million barrels of this total—11 days' supply—represent government-owned stockpiles in major industrialized countries. Although the commercial stock position measured in days of supply declined, [] there is room for further inventory drawdowns early this year (figure 2).

Non-Communist oil supply averaged 43 million b/d last year, including 18.5 million b/d from OPEC countries and 24.5 million b/d of non-OPEC supplies.¹ By the fourth quarter, OPEC crude production was averaging about 19.0 million b/d, 1.5 million b/d above the cartel's self-imposed ceiling (table 3). The largest overproducer was Saudi Arabia—Saudi production was 900,000 b/d above its implied quota of 5 million b/d as Riyadh continued its war-relief assistance to Iraq in the form of crude oil sales to Baghdad's customers. Riyadh's concern over the possible escalation of hostilities between Iran and Iraq apparently prompted it to store 45-50 million barrels

of oil in tankers outside the Persian Gulf. Several other OPEC members, including Libya and Qatar, also raised production over their quotas during the fourth quarter. []

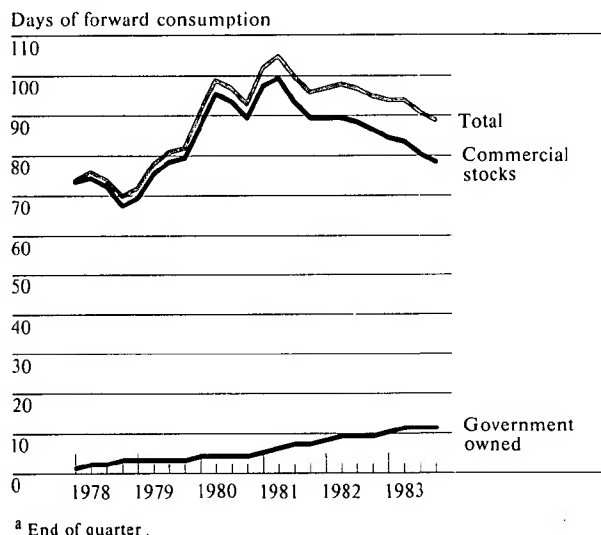
Overproduction has kept spot oil prices soft in recent months. Arab Light and Bonny Light crudes in January were quoted at \$28.60 per barrel and \$29.10 per barrel, respectively, about 40 to 90 cents below official prices. Prices of North Sea crudes averaged about 80 cents below official levels in January. Only a few heavy crudes remained at or near official prices. Weak spot prices forced the Soviet Union and Egypt to reduce their official prices by 50 cents to \$1 per barrel near yearend, and Oman effectively lowered its selling price by nearly 50 cents per barrel, according to press reports. These countries are now undercutting comparable OPEC crudes by about \$1 per barrel. Meanwhile, Statoil—the Norwegian oil company—reduced the price of its Statfjord crude by 20 cents per barrel in early January, and, although the British National Oil Corporation (BNOC) proposed freezing contract prices for first-quarter 1984 at current levels, two buyers terminated contracts; British prices could

¹ All references to OPEC oil production include 1 million b/d of natural gas liquids unless otherwise noted. OPEC's production ceiling of 17.5 million b/d includes crude oil only. []

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Figure 2
Non-Communist Oil Stocks on Land
by Quarter, 1978-83^a



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come under renewed pressure if spot prices weaken further. Several OPEC countries including Qatar, Indonesia, and Iran also began to discount oil prices to maintain sales. [redacted]

The Outlook for 1984

Consumption Forecast

We expect non-Communist oil consumption to rebound slightly in 1984 in response to the economic recovery, lower real oil prices, and a return to more normal weather patterns (see inset, page 5). In our base case scenario, we forecast a modest increase to about 44.8 million b/d, approximately 2 percent above year-earlier levels. In this base case, OECD countries, principally the United States, are expected to account for almost all of the 800,000-b/d increase. Achieving this consumption pattern implies OECD real GNP growth this year of about 3.5 percent, roughly what the major forecasting organizations now expect. Under the base case, we expect consumption

during the peak winter quarters to approximate 46 million b/d, compared with low seasonal requirements of 43 million b/d during the spring and summer quarters. [redacted]

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Inventory Patterns

The existence of surplus capacity worldwide and prospects for continued price weakness will encourage companies to attempt to maintain inventories at minimum levels. Oil companies still have some leeway to reduce inventories because of overproduction and weaker-than-anticipated consumption levels in second-half 1983. Our base case forecast assumes that total oil stocks decline by about 300,000 b/d in 1984; a 500,000-b/d drop in company stocks more than offsets a scheduled build in government-owned stockpiles. We assume that most of the excess commercial inventories—about 100-200 million barrels—will be depleted during first-half 1984. As a result, we anticipate a first-quarter inventory drawdown of approximately 2.4 million b/d, followed by little or no stockbuild during the second quarter. [redacted]

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Non-OPEC Oil Supply

[redacted] we expect non-OPEC oil supplies, including net Communist exports, to approximate 25 million b/d this year, an increase of about 500,000 b/d over year-earlier levels. We expect most of this increase to occur in the non-OPEC LDCs where production should rise by about 400,000 b/d to 7.6 million b/d. OECD oil production is also expected to increase slightly, to about 16 million b/d. With Soviet production holding roughly steady, net Communist exports should remain unchanged at about 1.5 million b/d. The following major changes are expected on a country-by-country basis:

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- [redacted] we expect Mexico to increase oil production by about 100,000 b/d in 1984, with most of the increase occurring in the second half.
- Oil production in Egypt will increase about 100,000 b/d this year as four new oilfields come on stream, [redacted]

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Table 3
Non-Communist Oil Supply, 1983 ^a

Million b/d

	Quota	Quarter				Year
		First	Second	Third	Fourth	
Total		40.9	41.9	44.5	44.8	43.0
OPEC		16.7	17.6	19.8	20.0	18.5
Algeria	0.7	0.7	0.6	0.8	0.8	0.7
Ecuador	0.2	0.2	0.2	0.2	0.2	0.2
Gabon	0.2	0.2	0.2	0.2	0.2	0.2
Indonesia	1.3	1.1	1.4	1.4	1.4	1.3
Iran	2.4	2.6	2.3	2.5	2.4	2.5
Iraq	1.2	0.8	0.9	1.0	1.0	0.9
Kuwait	1.1	0.8	0.7	1.0	1.0	0.9
Libya	1.1	1.3	1.1	1.1	1.2	1.2
Neutral zone ^b		0.2	0.4	0.5	0.3	0.4
Nigeria	1.3	0.8	1.4	1.4	1.3	1.2
Qatar	0.3	0.2	0.3	0.3	0.4	0.3
Saudi Arabia ^c	5.0	3.9	4.4	5.6	5.9	5.0
United Arab Emirates	1.1	1.1	1.2	1.2	1.2	1.2
Venezuela	1.7	2.0	1.7	1.7	1.7	1.8
OPEC crude	17.5	15.9	16.8	18.9	19.0	17.7
NGL		0.8	0.8	0.9	1.0	0.8
Non-OPEC		24.2	24.3	24.5	24.8	24.5
United States		10.3	10.2	10.2	10.2	10.2
Canada		1.6	1.5	1.7	1.7	1.6
Norway		0.6	0.7	0.6	0.7	0.7
United Kingdom		2.4	2.3	2.4	2.5	2.4
Other OECD		0.9	0.9	0.9	0.9	0.9
Non-OPEC LDCs		6.9	7.2	7.2	7.3	7.2
Of which:						
Mexico		2.8	3.0	3.0	3.0	2.9
Egypt		0.7	0.7	0.7	0.7	0.7
Net Communist exports		1.5	1.5	1.5	1.5	1.5

^a Because of rounding, components may not add to the totals shown; excluding refinery gain.

^b Neutral zone production is shared equally between Saudi Arabia and Kuwait and is included in each country's production quota.

^c Saudi Arabia has no formal quota; it acts as swing producer to meet market requirements.

• [] oil production in Brazil to rise about 100,000 b/d this year, and increases in production in other LDCs such as India, Angola, and Cameroon probably will add another 150,000 b/d to total non-OPEC LDC oil output.

• British oil production will average 2.5-2.6 million b/d in 1984 due to significant additions to productive capacity late last year. Norwegian oil output probably will also increase and average about 700,000 b/d. []

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Factors Affecting Oil Consumption

Predicting consumption patterns is difficult. Forecasters have had limited success in predicting the sharp declines in oil use during the past few years, and there remains considerable uncertainty about the pace of economic activity and its impact on oil consumption over the next two years. Despite these uncertainties key assumptions underlying our base case forecast include:

- *Organization for Economic Cooperation and Development (OECD) countries will experience a 3.5-percent increase in real GNP in 1984 compared with a 2.2-percent rise last year. Economic growth rates will vary among countries. US and Japanese economic growth are expected to approximate 5 percent and 4 percent, respectively, while West European countries as a group are expected to post about a 1.5-percent increase. This assumption is in agreement with a recent assessment by the OECD Secretariat.*
- *OECD energy demand is projected to grow almost 2 million barrels per day oil equivalent (b/doe)—or roughly 2 percent above 1983 levels—in response to the economic recovery, dampened conservation gains, and normal weather. Following a 3-percent drop in the energy-to-GNP ratio in 1982, the ratio fell slightly less than 3 percent last year.*

Continued strong apparent efficiency gains in part reflect the relatively warm winter weather and firm retail product prices in Western Europe and Japan caused by the strong dollar and increased taxes. Although lagged effects of past price increases and structural changes in the economies toward the less energy-intensive high-technology and service sectors will continue to spur conservation, we assume the energy-to-GNP ratio drops by 1 percent this year as falling real oil prices slow efficiency gains.

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Slowed by the recession, nonoil energy supplies in OECD countries remained flat last year. In 1984 we assume nonoil energy supplies will increase by about 1 million b/doe. Most of the increase will occur in nuclear power and coal to meet increased electricity demand. Most forecasters expect residual fuel oil demand to remain weak as firms encourage use of alternative fuels in electricity generation and industrial sectors. In Western Europe, gas demand is expected to rise as countries find markets for already contracted imported natural gas supplies. In Italy, for example, the government is attempting to replace one-fourth of fuel oil consumption in electric power with natural gas.

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Demand for OPEC Oil

If consumption, inventory, and non-OPEC production developments materialize as we expect under our base case scenario, demand for OPEC oil should average 19.5 million b/d in 1984, or about 1 million b/d higher than 1983 (table 4). With the continuing efforts to liquidate excess stocks and the anticipated seasonal decline in consumption, we estimate demand for OPEC oil will average about 19 million b/d during first-half 1984, slightly above the cartel's current production ceiling. We expect demand for OPEC oil to increase beginning in the third quarter, reaching perhaps 20 million b/d during the fourth quarter. This, however, assumes that economic recovery in Western Europe takes hold and that the US business expansion remains robust. This forecast is in

line with most industry estimates we have reviewed, and OPEC's own market assessment forecasts a reduction in demand for OPEC oil in first-half 1984.

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The Price Stability Issue in 1984

Given underlying demand conditions, the key to price stability during 1984—assuming that a supply disruption is avoided—will be producer cooperation. Under our base case scenario, we expect Saudi Arabia—in

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Table 4
Non-Communist Oil Supply and Demand ^{a b}

Million b/d

	1983					1984					1985
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Year	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Year	
Total consumption	45.0	42.9	43.0	45.3	44.0	46.5	43.2	43.5	46.0	44.8	45.4
Inventory change	-4.1	-1.0	1.5	-0.5	-1.0	-2.4	0.1	1.4	-0.5	-0.3	0.2
Supply	40.9	41.9	44.5	44.8	43.0	44.1	43.3	44.9	45.5	44.5	45.6
Total Non-OPEC	24.2	24.3	24.5	24.8	24.5	24.9	24.7	25.0	25.3	25.0	25.1
OECD	15.8	15.6	15.8	16.0	15.8	16.0	15.7	15.9	16.1	15.9	15.8
United States	10.3	10.2	10.2	10.2	10.2	10.2	10.2	10.2	10.2	10.2	10.1
Canada	1.6	1.5	1.7	1.7	1.6	1.6	1.5	1.6	1.7	1.6	1.5
United Kingdom	2.4	2.3	2.4	2.5	2.4	2.6	2.4	2.5	2.6	2.5	2.6
Norway	0.6	0.7	0.6	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Other	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9
Non-OPEC LDCs	6.9	7.2	7.2	7.3	7.2	7.4	7.5	7.6	7.7	7.6	7.9
Of which:											
Mexico	2.8	3.0	3.0	3.0	2.9	3.0	3.0	3.1	3.1	3.0	3.3
Net Communist exports	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.4
Implied demand on OPEC	16.7	17.6	20.0	20.0	18.5	19.2	18.6	19.9	20.2	19.5	20.5

^a Excluding refinery gain.^b Because of rounding, components may not add to the totals shown.

conjunction with other OPEC members—to control production to defend nominal oil prices. As indicated above, this assumes that demand for OPEC oil averages 19 million b/d in first-half 1984, rising to 20 million b/d in the fourth quarter. Should the economic recovery in the OECD fail to proceed as expected, however, our base case estimate of demand for OPEC oil could prove optimistic, and downward oil price pressures could intensify.

Factors Supporting Market Stability

We believe several underlying market conditions are working in favor of price maintenance in 1984:

- Unlike the sharp 6-percent decline in fourth-quarter oil use in 1982, oil consumption actually increased in the same period in 1983.

- Weather conditions in North America are decidedly colder than last year, boosting consumption of fuel oil and other heating fuels.
- The level of excess inventories is less than that of a year ago. Oil stocks at yearend stood at 90 days of consumption, compared with 95 days at yearend 1982.
- OPEC crude production of 18.7 million b/d in December was about 500,000 b/d below year-earlier levels.

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- Spot oil prices have weakened, but the decline is not as sharp as last year. Spot prices for most crudes are now less than \$1 below official prices, as compared with a \$3-to-\$4 spread early last year (figure 3).
- OPEC reaffirmed its nine-month-old production and price accord in December 1983. [redacted]

In our view, Saudi Arabia will play the major role in determining oil price developments from the producer side. Although they may believe OPEC oil is still overpriced, the Saudis are mindful of the dangers of an uncontrolled round of price cuts and the damage it could do to them. Unlike last year, the Saudis have not issued public threats to reduce the price of oil and have, in fact, stated their support for the current price. As a result, we feel the Saudis currently view defense of OPEC's \$29 per barrel marker price as the best option available. Indeed, Saudi production has fallen gradually from its September 1983 peak of 6.2 million b/d to 5.2 million b/d in January. If demand follows the first-half 1984 pattern we now expect, Riyadh probably will be well positioned to defend prices. [redacted]

If prices hold steady and the base case demand for OPEC oil materializes, OPEC countries as a group will register a current account deficit of about \$21 billion this year. A Saudi decision to allow output to stay at or below 5 million b/d would allow other OPEC producers to increase their production by 1 million b/d. Although the cartel is not scheduled to formally consider changes until July, recent statements by Saudi Oil Minister Yamani indicate that Riyadh believes Nigeria should be given preferential treatment by OPEC in the matter of an increase in its production quota. An increase in oil production could provide sufficient oil revenues for financially pressed members such as Nigeria, Venezuela, and Indonesia to relax austerity measures in 1984. On the basis of current prices, an increase of 300,000 b/d in Nigerian production to 1.6 million b/d in 1984 would provide Lagos with an additional \$3.3 billion in oil revenues—enough to cover more than 30 percent of the total cost of projected Nigerian imports in 1984. A 200,000-b/d increase in production for both Venezuela and Indonesia would provide these countries with an additional \$2 billion and \$2.2 billion in oil revenues, respectively. [redacted]

The Price Decline Scenario

We expect OPEC to cooperate to maintain oil prices this year, but in the absence of a sustained economic recovery in Western Europe or a drop in US growth prospects, the situation could prove very difficult for OPEC to manage. Demand for OPEC crude oil, for example, could be 1-2 million b/d less than we now expect if the business cycle weakens or if downward inventory adjustments are greater than we anticipate. We believe OPEC would be hard pressed to accommodate such a sharp drop in demand, and several OPEC countries probably would ignore their production ceilings. Under these conditions, Saudi output could be forced to unacceptably low levels, and Riyadh might abandon all attempts to support the existing price structure (see inset, page 11). [redacted]

It is difficult to predict how far prices would fall if OPEC becomes unable or unwilling to defend the current \$29-per-barrel benchmark. Because a modest cut in oil prices would not increase demand for OPEC oil significantly in the short term, the financial situations of OPEC's hardest pressed members would probably deteriorate further in the event of a price decline. We estimate that for every \$1-per-barrel annual average decline in nominal prices, OPEC's current account deficit would increase by \$6 billion. Should other currencies significantly appreciate against the US dollar in coming months—reducing OPEC's purchasing power—financial pressures on cartel members would be compounded. Under this scenario, prospects for political instability could substantially increase as well.² [redacted]

Countries such as Nigeria, Venezuela, and Indonesia are under extreme pressure to increase oil output to maximize export earnings:

- Nigeria—OPEC's weakest link and possessor of a new government—in particular continues to suffer economic woes. Oil revenues have slumped dramatically from about \$24 billion in 1980 to an estimated \$11 billion in 1983.

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- Venezuela will find it increasingly difficult to comply with its 1.7 million b/d quota and still meet revenue requirements.
- Indonesia has been forced to slash imports to reduce its deficit.
- Other OPEC members, particularly Iraq, also need to increase oil production to increase earnings. [REDACTED]

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We believe one indicator of the pressure on OPEC members to raise production is the difference between desired production and the actual level of demand for OPEC oil. To estimate OPEC's desired production, we calculated the level of oil production needed to maintain financial assets at yearend 1983 levels. On this basis, we estimate that OPEC's desired crude production in 1984 approximates 23 million b/d—some 4-5 million b/d above our baseline demand estimate (table 6). Statements by Saudi Oil Minister Yamani also indicate that 23 million b/d is the minimum "comfortable" level for OPEC as a whole.

[REDACTED]

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For the consuming countries, a further reduction in nominal oil prices could have substantial positive economic impacts including lower inflation, higher economic growth, and reduced interest rates. Moreover, financial pressures in key debtor oil-importing countries—Brazil, Argentina, and the Philippines, for example—would ease if prices fall. Some countries have already experienced a measure of these positive impacts as a result of last year's \$5-per-barrel decline in nominal oil prices. However, the strength of the US dollar and tax policies in France and Italy, for example, have prevented the full benefit of lower oil prices from being transmitted to final consumers.

[REDACTED]

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Prospects for 1985

The Market Outlook

Even if OPEC members get through 1984 with stable prices, the outlook for oil consumption in 1985 indicates that OPEC will continue to face challenges to its cohesion. Building on our 1984 base case demand scenario, we expect only a modest increase in non-Communist oil consumption of 600,000 b/d in 1985

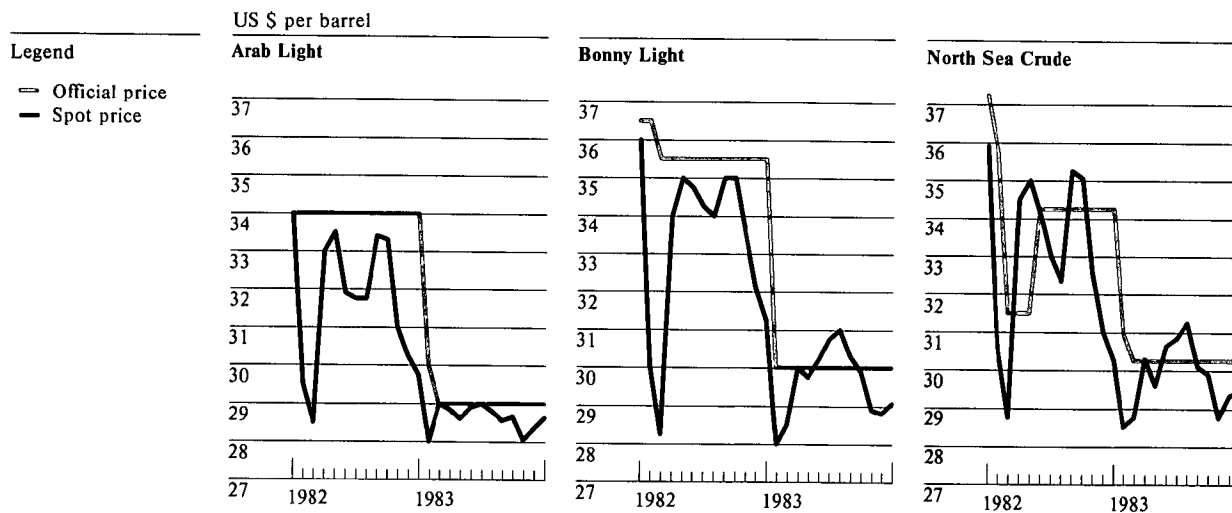
as continued improvements in energy efficiency combined with growing use of nuclear power, natural gas, and coal hold down growth in oil consumption. On the basis of this consumption estimate and the expectation that inventory levels and non-OPEC oil supplies will hold relatively stable, we estimate that demand

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Figure 3
Oil Price Trends, 1982-January 1984^a



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for OPEC oil will approximate 20-21 million b/d.³ Under this demand scenario, we expect supplies to be ample to keep a soft-to-stable market and OPEC to have to continue to restrain output, with few, if any, countries able to produce at desired levels. If demand for OPEC oil is below our baseline scenario and if OPEC fails to experience an upturn in market share, the cartel could have a difficult time maintaining the price structure. Indeed, some economists are now predicting an economic downturn in 1985 that could depress demand for OPEC oil. A failure to realize any substantial growth in market share in 1985 would be

³ Assumptions underlying this forecast include: OECD real GNP growth of 2.7 percent; a continued slight decline in the energy-to-GNP ratio; constant nominal oil prices; and an increase of about 1 million b/d in nonoil energy demand in OECD countries.

very demoralizing for the cartel, because several members have already suffered financial problems for the past two to three years.

Iraq and Iran—Increased Production Possible

Constraints imposed by the continuing war will limit the likelihood of any major increase in production from Iran and Iraq in 1984. On the basis of recent initiatives by the Iraqis to expand export outlets, however, we believe developments in Iraq and Iran will play a crucial role in determining market conditions in 1985:

- If the war continues and Iraq and Iran maintain exports at or near current levels, other OPEC members will be able to share any increase in oil

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Oil Price Indicators

Key factors to observe over the coming months that might portend a decline in oil prices are:

- *Levels of OPEC production well in excess of the cartel's 17.5 million b/d quota, with Saudi output in excess of 5.0 million b/d a key factor.*
- *Absence of a sustained rebound in oil consumption.*
- *Falling spot crude prices that dip \$2 to \$4 below official prices.*
- *Competition between the United Kingdom and Nigeria for market share.*
- *Exodus of buyers for North Sea crudes, forcing BNOC to step up spot market sales substantially.*
- *Saudi Arabia's hints that it is no longer willing to defend the benchmark.*
- *Additional price discounting, barter deals, or concessional credit terms in countries such as Libya, Iran, and Nigeria.* [redacted]

demand among themselves and avoid the contentious issue of higher production quotas for the belligerents.

- *Iraq's current attempts to increase oil export capacity and revenues could place Baghdad in a position to boost production and demand a higher quota.⁴ A proposal to link to the Saudi oil pipeline to the Red Sea appears to afford Iraq an opportunity to increase exports by 500,000 b/d in 1985. Should Iran match any increase in Iraqi oil exports—as Tehran has threatened—an additional 1 million b/d of exports would offset the expected increase in demand and keep the oil market soft.*
- *An end to the hostilities could allow Iraq to increase its export capacity by 2 million b/d or more by reinstalling offshore loading facilities in the Persian Gulf and building a new pipeline link. If Iran also raises its exports by nearly 1 million b/d, substantial cuts by other producers would be needed just to maintain price stability.* [redacted]

Table 6
OPEC Desired Crude Oil
Production, 1984 ^a

Million b/d

	Desired
Total OPEC	22.8
Algeria	0.8
Ecuador	0.3
Gabon	0.2
Indonesia	1.7
Iran	2.6
Iraq	1.6
Kuwait ^b	1.2
Libya	1.6
Nigeria	1.5
Qatar	0.4
Saudi Arabia ^b	7.6
United Arab Emirates	1.2
Venezuela	2.1

^a Crude oil production needed to maintain financial assets at yearend 1983 levels.

^b Neutral Zone production divided between Saudi Arabia and Kuwait.

In our judgment, OPEC countries such as Nigeria, Venezuela, and Indonesia probably would be unwilling to lower output to offset higher production from Iraq and Iran. Indeed, these countries—especially Nigeria—are eager to increase production and revenues. Even if these and other OPEC members were to agree to limit output to current quotas for 1985, an additional 3 million b/d of oil from Iraq and Iran could only be accommodated by lowering Saudi production to less than 4 million b/d. Because of their own internal needs, we believe such an outcome would give the Saudis pause and increase the risk of an oil price slide. [redacted]

Other Market Pressures

We expect several factors to grow in significance over the next few years, making it even more difficult for producers to prevent an oil price decline. [redacted]

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the spot oil market has become increasingly active in recent years. While accurate measurement of the volume of oil traded on the spot market is difficult,

the spot market now constitutes 20 to 25 percent of total non-Communist oil trade, compared with 5 to 10 percent in the 1970s. Increasing spot market sales and the introduction of crude oil futures contracts have increased market responsiveness, buyer flexibility, and price transparency, while reducing the volume of oil sold on a traditional contract basis. As a result, to boost oil sales, some producers are modifying contract terms to make deals more attractive. For example, some OPEC countries are:

- Offering buyers term contracts with prices set at the prevailing spot price at time of lifting.
- Reducing the length of the contract.
- Extending buyer credit terms—effectively discounting prices.
- Reducing or eliminating restrictions on the destination or resale of crude oil purchases.

Price discounting by OPEC members on contract sales adds to price weakness in soft market periods and increases pressure on OPEC's official price structure (figure 4). Indeed, even without official action by OPEC, the growing volume of oil traded as spot sales effectively reduces average world crude oil prices when the market is soft.

Oil producers are expanding downstream operations. Refinery capacity within OPEC increased by more than 1 million b/d from 1979 to 1981, and, according to the International Energy Agency (IEA), OPEC will add another 2-3 million b/d to capacity over the next several years. About half of this increase is expected to occur in the Persian Gulf. Projects under construction in Saudi Arabia alone are expected to add as much as 1 million b/d to capacity in the next few years. Product export capacity in OPEC could approximate 3.5 million b/d in 1985 or 1986, roughly 20 percent of expected total OPEC oil exports (table 7). Purchases of existing European capacity by OPEC members, primarily Kuwait, will also increase OPEC's role in downstream operations. Kuwait recently purchased both refining and marketing operations in Denmark, the Netherlands, and Italy and is reportedly seeking additional facilities in the United Kingdom. OPEC oil producers in recent years have purchased or are partners in about 350,000 b/d of

Table 7
OPEC: Product Export Capacity

Thousand b/d

	1981		1985/86 ^a	
	Refining Capacity	Product Export Capacity	Refining Capacity	Product Export Capacity ^b
Total OPEC	4,670	1,074	7,840	3,400
Saudi Arabia	570	— 100	1,900	1,000
Kuwait	594	333	720	950
Venezuela	1,400	490	1,600	500
Indonesia	471	85	940	350
Algeria	300	136	450	250
Libya	130	32	360	200
Others	1,205	98	1,870	150

^a Projections based on IEA data.

^b Exportable product capacity calculated based on 90 percent utilization less domestic consumption. Excludes natural gas liquids.

refining capacity in Western Europe, and, according to press reports, purchases by private Saudi companies reportedly total an additional 170,000 b/d (table 8).

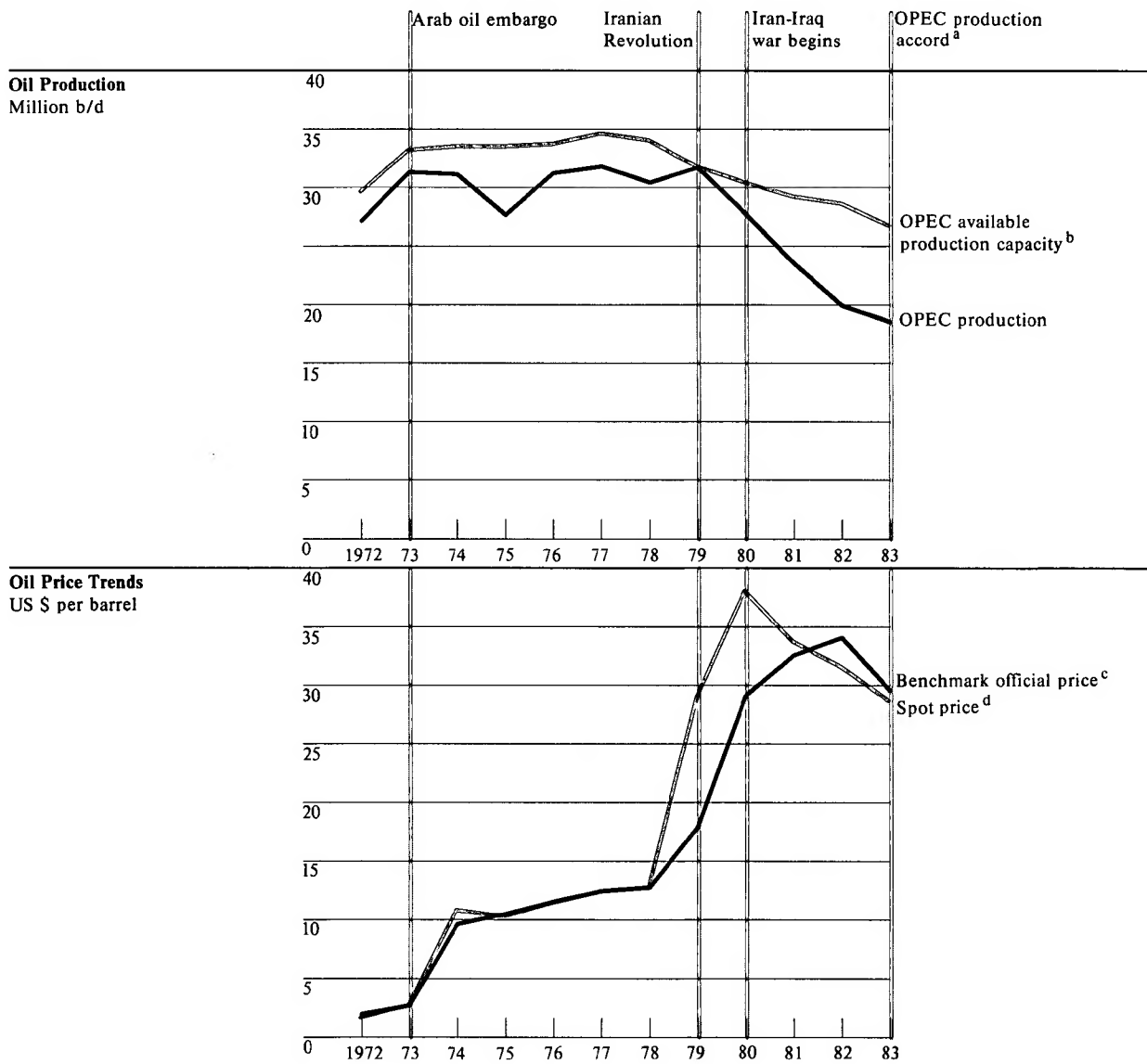
OPEC countries' growing role in product markets, initially planned in order to capture the profits in this sector, may cause additional problems for the organization as it struggles to maintain control of oil prices and production in the next few years. Oil product prices are not included in the cartel's official price structure, and OPEC currently has little recourse if producers choose to discount product prices, despite the fact that such discounts tend to erode crude oil prices. Furthermore, because product sales are more difficult to monitor than crude sales, producers wanting to increase market share may be better able to disguise overproduction.

We believe increasing OPEC penetration into product markets may also be cause for increasing tension between these countries and consuming countries in

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Figure 4
Oil Production and Price Trends, 1972-83



- ^a Benchmark price falls five dollars per barrel.
^b Reflects government production ceilings.
^c Actual contract sales prices for Arabian Light.
^d Annual average.

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Table 8
Major OPEC Downstream
European Acquisitions,
as of February 1984

	Refining Capacity (barrels per day)	Retail Outlets
Kuwait—Kuwait Petroleum Corporation (KPC)		
Netherlands/Belgium/Luxembourg (February 1983)	75,000	750
Sweden/Denmark (March 1983)	85,000	825
Italy (January 1984)	80,000	1,500
Total to date ^a	240,000	3,075
Saudi Arabia—First Arabian Corporation and Arabian Sea First		
Italy/Switzerland (April 1983)	170,000	NA
Venezuela—Petroven		
West Germany (December 1983)	105,000	NA

^a KPC has expressed interest in purchasing additional downstream facilities in the United Kingdom consisting of a 100,000 b/d refinery and 400 retail outlets.

^b Purchased by private Saudi buyers.

^c Fifty-fifty joint venture in a 210,000 b/d refinery with the West German company Veba.

Europe. Reduced oil consumption has created a worldwide surplus of refining capacity, and many OECD refineries have been shut down, particularly in Western Europe. Much of the adjustment, however, will be offset by OPEC's increased capacity. According to the IEA, total OECD capacity declined by more than 5 million b/d from 1979 to 1982, and additional cutbacks are required. Moves to further reduce European capacity probably will be difficult and slow, however, and West European countries may decide to impose import fees on oil products to protect the domestic industry and jobs, according to one industry source. Thus far, OPEC has no strategy for coping with these problems, but, given their access to low-cost crude feedstocks, cartel members are in a position to embark on a ruinous price war to force additional refinery closures and increase OPEC's market share.

Market Vulnerability—The Iran-Iraq Risk

Although we expect the market to remain weak over the next year or so, the volatile situation in the Middle East could cause a rapid turnabout in the market. Iraq's deteriorating economic situation and its growing frustration over the protracted war with Iran could prompt Baghdad to initiate attacks in the coming weeks against oil shipping in the Persian Gulf in an effort to bring an end to the conflict. Such action might induce Iran to carry out its oft-repeated threat to close the Gulf to shipping or to strike out against the oil facilities of Iraq and its Persian Gulf allies.⁵

Under these conditions, the world oil market could tighten quickly and cause at least a temporary runup in spot prices for several reasons:

- Uncertainty regarding the extent of damage to the oil industry in the Gulf and the length of any supply disruption, including the possibility of further attacks on oil facilities, probably would encourage increased spot market purchases.
- A minimum of available surplus capacity in non-Communist countries is outside the Gulf; only about 3 million b/d of the current surplus of 8 million b/d is located outside the region.
- Commercial stocks have been drawn down to near normal levels, and there is little surplus to offset a disruption; government-held stockpiles might not be used initially to prevent price runups.

While sizable runups in oil prices are likely during a major disruption of Persian Gulf oil supplies, we cannot predict how high prices would rise or how long such increases might be sustained. We believe the key factors under any circumstances are industry and public perceptions of the disruption and the timing of

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such an event. A price runup of any nature or duration could impact on economic growth, inflation, financial markets, and political stability. [REDACTED]

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Because of the many economic variables that come into play, the precise impacts of future supply disruptions are difficult to gauge. Using the CIA-linked econometric model and allowing for the 2 million b/d of excess capacity that the industry believes is needed to maintain market equilibrium, we have attempted to measure the order of magnitude of economic impacts from a supply disruption. Our analysis indicates that for each 1 million b/d net supply shortfall, real oil prices would rise by about \$10 per barrel and OECD GNP growth would decline by about 0.5 percentage point. In the event of a major price increase, heavily indebted oil-importing LDCs would be hard pressed to finance higher oil import bills given the reluctance of commercial creditors to further increase their exposure. We estimate that a \$10 price increase would add another \$5 billion in foreign exchange requirements for the five largest LDC commercial debtors—Brazil, South Korea, Chile, the Philippines, and Morocco. [REDACTED]

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